

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of)

1998 Biennial Regulatory Review --)
Review of Depreciation Requirements)
for Incumbent Local Exchange Carriers)

CC Docket No. 98-137

United States Telephone Association's Petition)
for Forbearance from Depreciation Regulation)
of Price Cap Local Exchange Carriers)

ASD 98-91

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COMMENTS OF BELL SOUTH

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COMMENTS OF BELL SOUTH

I. SUMMARY AND INTRODUCTION

On September 21, 1998, the United States Telephone Association ("USTA") filed a Petition ("USTA's Petition") with the Federal Communications Commission ("Commission") for Forbearance from Depreciation. Essentially, USTA's Petition requested that the Commission completely forbear from regulating depreciation expenses, including rules regarding depreciation reserve. The Commission issued a Public Notice and sought comments concerning USTA's Petition.¹ Subsequently, on October 14, 1998, in accordance with its statutory obligations to perform a biennial review of regulation, the Commission issued a *Notice of Proposed Rulemaking* ("Notice") in CC Docket No. 98-137, to Review the Depreciation Requirements for

¹ United States Telephone Association Files Petition for Forbearance from Depreciation Regulation of Price Cap Local Exchange Carriers, ASD 98-91, *Public Notice*, (DA 98-1964) (released September 29, 1998).

Incumbent Local Exchange Carriers.² The Commission combined the pleading cycles of USTA's Petition and the Notice in its Public Notice, *Modification of Pleading Cycle for United States Telephone Association's Petition for Forbearance From Depreciation Regulation of Price Cap Local Exchange Carriers*, ASD 98-91, DA 98-2092, released October 16, 1998.

Accordingly, BellSouth has combined its comments for these proceedings.

Unfortunately, the Notice does not propose any meaningful reduction in depreciation regulation. It merely offers miniscule adjustments where major revisions are needed. Indeed, BellSouth believes the Commission should close its depreciation rulemaking proceeding and grant USTA's Petition. Forbearance is the only sensible path the Commission can take to fulfill its statutory obligation pursuant to Section 11 of the Telecommunications Act of 1996 ("1996 Act"). Continuation of the same depreciation prescriptive process for price cap local exchange carriers ("LECs") places them in a plight of Sisyphus. Indeed, any suggested changes to the status quo, short of complete forbearance, would merely be efforts to prolong the life of a broken, decaying structure. While BellSouth does not oppose all of the proposals set forth by the Commission in the Notice, BellSouth finds these proposals to fall far short of the changes needed and warranted to promote the objectives of the 1996 Act. Accordingly, BellSouth focuses its comments first on forbearance, as urged by USTA's Petition. Then, the remaining comments discuss the shortcomings of the Notice and the list of concerns the Commission identified as causing "a carrier's depreciation [expense to] remain [a] significant [issue], even under current price cap rules"

² In the Matter of 1998 Biennial Regulatory Review -- Review of Depreciation Requirements for Incumbent Local Exchange Carriers, CC Docket No. 98-137, *Notice of Proposed Rulemaking* (FCC 98-170), released October 14, 1998.

II. Regulation of Depreciation for Price Cap LECs is Ripe for Forbearance.

As stated in USTA's Petition, forbearance from depreciation regulation is long overdue. These regulatory requirements are not only unnecessary in light of the carriers' obligations to follow Generally Accepted Accounting Principles ("GAAP") requirements, but they also hinder investment recovery in an increasingly competitive environment. Additionally the asset lives prescribed to calculate the regulatory depreciation expense are significantly longer than the economic lives of these assets.

Moreover, the need for such regulation has been eliminated by the implementation of price cap regulation. Price cap regulation focuses on prices a LEC may set for its services instead of the cost to provide the services.³ Indeed, the cost of the service is no longer the basis on which a price cap LEC sets the price it charges a customer for a service.⁴ Such useless regulation conflicts directly with the de-regulatory intent of the 1996 Act. When it passed that legislation, Congress clearly recognized that many carriers are saddled with regulation that has outlived its usefulness and should therefore be eliminated. Consequently, Congress included Section 10 in the 1996 Act as a mechanism to relieve the industry of such unneeded regulation. As demonstrated in Section III herein, no regulation is more ripe for application of Section 10 than depreciation for price cap LECs. Accordingly, the Commission should grant USTA's Petition.

³ In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, *Second Report and Order*, CC Docket No. 87-313, 5 FCC Rcd 6786, 6792 ¶ 47 (1990) ("Price Cap Order").

⁴ A LEC's costs may become relevant if the carrier seeks a low-end adjustment. Continued regulation of costs, including depreciation, to analyze the infrequent requests for a low-end adjustment is a significant waste of resources. As stated in USTA's Petition, if a price cap LEC seeks a low-end adjustment, the Commission should place the burden on that LEC to justify its costs which would include depreciation expense.

A. Regulation of Depreciation is No Longer Needed for Regulatory or Other Reporting Purposes

1. GAAP Accounting Is Used for External Reporting and Management Purposes.

Since 1995, BellSouth has determined its own depreciation rates for external reporting in conformance with GAAP accounting. This is required by the Securities and Exchange Commission (“SEC”) to ensure that reporting of public information to investors is fair and reasonable.

Under GAAP, depreciation assures periodic recognition of the consumption of an asset. The original cost of an asset is allocated (charged to expense) systematically and rationally over the asset’s useful life.⁵ In order to comply with GAAP, carriers are required to match costs to the benefited period (the matching principle), and to apply accounting principles and concepts consistently from period to period (the consistency principle).

To comply with GAAP’s matching principle, companies must match costs to the period in which revenues produced by those costs are earned. Since depreciable assets provide benefits over more than one accounting period, compliance with the matching principle requires the cost of these assets be allocated among the benefited periods. Depreciation expense represents the portion of an asset’s cost allocated to the current accounting period.

Statement of Financial Concepts No. 5, Recognition and Measurement in Financial Statements of Business Enterprises, states: “some expenses, such as depreciation and insurance, are allocated by systematic and rational procedures to the periods during which the related assets are expected to provide benefits.”

⁵ American Institute of Certified Public Accountants (“AICPA”), Accounting Research Bulletin No. 43: Restatement and Revision of Accounting Research Bulletins (June 1953), Chapter 9, Section 5.

The financial community and management have therefore realized that a carrier cannot manipulate its depreciation expense without violating the matching principle of GAAP. Moreover, GAAP requires that this principle be applied on a consistent basis. Indeed, the Accounting Principles Board (“APB”), predecessor to Financial Accounting Standards Board (“FASB”) has addressed the requirement for consistency in applying accounting principles. APB Opinion No. 20, at paragraph 15, states in pertinent part: “in the preparation of financial statements there is a presumption that an accounting principle once adopted should not be changed in accounting for events and circumstances of a similar type.”

The users of BellSouth’s financial statements, whether investors or management, are confident that the expense recorded under GAAP principles for depreciation is reasonable and ignore regulatory depreciation in any of their decisions. Moreover, as discussed below, BellSouth currently sets depreciation rates for intrastate services for its state regulatory books according to GAAP. Thus, the regulatory depreciation exercise is a burdensome practice followed only to satisfy the Commission.

2. Price Cap Regulation Eliminates Any Need for Prescriptive Rules for Depreciation.

As explained above, depreciation is an attempt to recover the cost of an asset over the asset’s economic or useful life. The amount of expense charged to any one accounting period obviously depends on the life assigned to the asset. Under rate-of-return regulation service prices were determined by the magnitude of the costs a carrier incurred. Conceivably, a carrier could request higher annual depreciation expense by assigning a shorter life to an asset. Consequently, as USTA’s Petition states “[u]nder rate-of-return regulation, depreciation regulation has been used as a tool for limiting the LEC’s apparent costs of service by adopting long asset lives in order to reduce depreciation rates. Doing so lowered the LEC’s ostensible

costs of service for regulatory purposes, which under rate-of-return regulation translated to decreased rates.”⁶ Accordingly, the Commission applied the existing regulation to supposedly protect the rate-payer.

Under price cap regulation, however, unless a carrier seeks a low-end adjustment to its price caps, the depreciation expense that a carrier incurs each year does not directly affect the rates the carrier charges its customers. Regulating service price instead of service cost eliminated the link between prices and costs. With this link broken, continued regulation of depreciation becomes nothing more than regulation for the sake of regulation.⁷

This has been fully demonstrated in the state public service commissions (“PSCs”) in BellSouth’s in-region states. Upon approving price cap regulation for intrastate services, the PSCs recognized the inconsistent logic of continuing to require prescribing rates for depreciation. Accordingly, PSCs allow BellSouth to set its own intrastate depreciation rates. BellSouth has had the authority to set these rates in Alabama, Georgia and Kentucky since 1995; in Louisiana, Mississippi, North Carolina and South Carolina since 1996; and, in Florida and Tennessee in 1998. The Commission should follow the lead of the PSCs in the BellSouth in-region states and allow incumbent LECs to set their own depreciation rates.

B. Current Depreciation Regulation Distorts Asset Lives and Depreciation Rates

Price cap regulation eliminates the need for regulation in more ways than one. As already discussed, under rate-of-return regulation higher costs, including depreciation, enabled carriers to raise service rates because rates were directly linked to costs. Conversely, the

⁶ USTA’s Petition at 7-8.

⁷ The Notice identified several situations in which the Commission contends “a carrier’s depreciation remains significant.” BellSouth addresses each of these situations individually in Section IV below.

Commission's interest was to keep costs low so rates too would be low. As one step toward achieving that goal, the Commission prescribed asset lives for purposes of calculating depreciation rates, thus limiting the amount of depreciation cost the carriers could incur. The prescribed rates generally reflected lives in excess of the assets' economic lives, particularly for the technology sensitive accounts. Prescribing rates based on these extended lives lowered the annual depreciation expense.

Under price cap regulation LECs can no longer raise rates merely because they have higher costs. Instead of allowing the LECs to set their own depreciation rates based on market conditions, however, the Commission continues to prescribe unreasonably long asset lives resulting in low depreciation rates. These depreciation rates not only overvalue fixed assets through an undervalued reserve, but cause regulated earnings to be overstated each year. Unless LECs are allowed to set their own depreciation rates based on actual market conditions, regulatory earnings will continue to be overstated and create the false impression that any price cap review should be focused upon driving caps down.

III. Pursuant to Section 10, The Commission Should Grant USTA's Petition and Forbear from Depreciation Regulation.

Forbearance from depreciation regulation is not only a logical step to take in the current regulatory environment, but also consistent with Congress' intent in the 1996 Act. Congress amended Section 220(b) to change the Commission's obligations regarding depreciation. Prior to the amendment, the Commission was required to prescribe lives that carriers were required to use to calculate their depreciation rates. The amendment removed the requirement, however, and gave the Commission discretion on whether to prescribe such rates. Moreover, when such discretion exists, Congress promulgated Section 10 of the 1996 Act to require Commission

forbearance from regulation when regulation is no longer needed. Section 10 of the 1996 Act states:

- (a) **REGULATORY FLEXIBILITY** — Notwithstanding section 332(c)(1)(A) of this Act, the Commission shall forbear from applying any regulation or any provision of this Act to a telecommunications carrier or telecommunications service, or class of telecommunications carriers or telecommunications services, in any or some of its or their geographic markets, if the Commission determines that—
 - (1) enforcement of such regulation or provision is not necessary to ensure that the charges, practices, classifications, or regulations by, for, or in connection with that telecommunications carrier or telecommunications service are just and reasonable and are not unjustly or unreasonably discriminatory;
 - (2) enforcement of such regulation or provision is not necessary for the protection of consumers; and
 - (3) forbearance from applying such provision or regulation is consistent with the public interest.

Thus, where the conditions set forth in the statute are met, the Commission has a statutory obligation to forbear from regulation. As demonstrated below, when the Commission analyzes depreciation it should find that the criteria of Section 10 for forbearance are clearly met.

A. Regulation of Depreciation Is Not Needed to Ensure that Charges, Practices, or Classifications Are Just and Reasonable.

The first criterion set forth in Section 10 of the statute clearly favors forbearance from depreciation rate represcription. Indeed, in its Notice the Commission recognized that price cap regulation “eliminated the direct link between costs and prices” Accordingly, as demonstrated above by BellSouth and in USTA’s Petition “...LEC prices for interstate access service no longer directly depend on their costs of service derived through regulation. Access prices are limited by caps that, in turn, are determined under the price cap formula. That formula relies on economic indicators and exogenous adjustments, not LEC cost of service.”⁸

⁸ USTA’s Petition at 10. Indeed, changes in depreciation costs represent endogenous adjustments and thus have no impact on rates.

Consequently, regulation of a price cap LEC's depreciation is not necessary to ensure that depreciation charges, practices, classifications, or regulations by, for, or in connection with such a LEC are just and reasonable.

Even though it recognized that price cap regulation severs the link between costs and prices, the Notice alleged that there were nonetheless several situations for which some regulation of depreciation costs was still required.⁹ These situations appear to affect the Commission's opinion of whether regulation is needed to ensure that the depreciation "charges, practices, classifications, or regulations by, for, or in connection with the LEC are just and reasonable." BellSouth demonstrates below, however, that none of the situations justify the continued regulation of depreciation for price cap LECs.

B. Depreciation Regulation Is Not Necessary for the Protection of the Consumer.

To determine whether the second criterion Congress established in Section 10 is met the Commission must evaluate whether continued regulation of depreciation is needed to protect consumers. Once again, analysis of this factor fully supports forbearance from depreciation regulation. Continued regulation of depreciation is unnecessary for consumer protection because prices for services are no longer directly impacted by depreciation rates (costs), other protection mechanisms are in place to more than adequately protect consumers, and increased competition is prevalent in the market place.

Without belaboring the point, price cap regulation provides consumers full protection against inflated prices. Price cap LECs no longer base prices on the cost of service. Accordingly, the Commission no longer has incentive to keep costs artificially low in order to keep customer rates low.

⁹ Notice ¶ 6.

In addition to the protection offered consumers through price cap regulation, other safety nets exist to ensure that consumers are protected. For example, LECs, as are all public companies, are required to maintain their books of account in accordance with GAAP which provided professional standards for reporting. Also, independent auditors review depreciation during the annual financial audit to ensure compliance with accounting and auditing safeguards.

C. Forbearance is in the Public Interest.

Forbearance of depreciation regulation is in the public interest for several reasons. First and foremost, forbearance from such regulation is consistent with the de-regulatory intent of the 1996 Act. Second, eliminating the prescription process will relieve both the LECs and the Commission of unnecessary regulation and will allow them to refocus limited resources on worthwhile endeavors.

Third, market forces created by competition between carriers for end-user customers, rapid technological advances in the development of communications equipment and the impact of competition among manufacturers of that equipment should be the factors that determine equipment economic lives. These factors are interrelated and interdependent. For example, customers will select the carrier that can offer the most useful products and features at a competitive price which drives carriers to demand the best products at the lowest prices from its vendors. Competition also motivates manufacturers to provide carriers with the latest equipment with the newest features as quickly as possible. Thus, competition in both the consumer and manufacturing markets increases the pace at which equipment becomes obsolete. Consumers (both wholesale and retail) demand for new functions and capabilities will continue to compel rapid changes in technology. Conversely advances in technology will drive competition, which as already noted, increases the pace at which equipment must be replaced. Accordingly, the

public interest is best served when carriers are able to set depreciation rates pursuant to market conditions, not regulation.

Finally, forbearance will allow the investment and state regulatory communities the ability to reconcile the financial data of the LEC industry to that of the Commission. In today's confusing environment, one cannot simply ask for an analysis of depreciation expense and reserve. The request must also include the set of books to which the request pertains. This is extremely confusing to both internal and external sources.

IV. The Proposals of the Notice Should Be Abandoned In Favor of Forbearance

A. The Notice Is Void of Worthwhile Change

In these comments BellSouth has demonstrated that the Commission should grant USTA's Petition and forbear from regulation of depreciation. The Notice, however, proposes limited relief from this unnecessary regulation by only three changes to current rules. The Notice proposes to modify the depreciation process by reducing required filings to four summary exhibits, increasing life ranges for digital switching equipment, and changing the treatment of salvage and cost of removal.¹⁰ None of these three proposals will bring any meaningful benefit to the incumbent LECs. Indeed, the salvage value and cost of removal proposal will only burden the LECs because it is in potential conflict with GAAP.

1. Filing and Prescription Procedures.

The reduction in filing requirements proposed in the Notice, although helpful, offers little in savings. The exhibits proposed by the Commission are "summary" reports and, as such, underlying details must still be maintained at existing levels and summarized into the proposed exhibits. Thus, the work required to prepare the summary exhibits will be basically the

¹⁰ The Notice also asks for comments regarding the low-end adjustment but does not offer a proposal.

same as the work required for the detailed study. Moreover, such reduction is far short of what is needed and justified.

2. The Proposed Equipment Life Ranges Do Not Reflect Current Market Conditions.

The Notice proposes to expand the life range for digital switching equipment from the current range of 16 to 18 years to a range of 13 to 18 years. BellSouth, however, prepared a detailed depreciation study and determined that the appropriate life for digital switching equipment is 10 years. In fact, 10 years is the life BellSouth uses for both SEC and state regulatory reporting. Once again the Commission has prescribed an equipment life that does not properly reflect the economic life of the asset.

As discussed repeatedly herein, the Commission should forbear from any regulation of depreciation. If the Commission fails to forbear, however, it should prescribe a range of lives that matches current market conditions. Current ranges were set based on lives established in 1990 and 1991. Consistent with BellSouth's most recent depreciation study filed with the Commission, BellSouth proposes the following lives for other accounts:

Digital Switching	8 to 10 years
Circuit Analog	6 to 8 years
Circuit Digital	8 to 10 years
Aerial Cable – Metallic	12 to 16 years
Underground Cable – Metallic	10 to 14 years
Buried Cable – Metallic	12 to 16 years
Computers	3 to 5 years

The lives BellSouth now uses for SEC and state regulatory reporting are within these ranges.

3. The Proposed Treatment for Salvage and Cost of Removal Faces a Potential Conflict with GAAP

The Notice requests comments on two proposals related to the accounting for cost of removal and salvage ("CR&S"). The current practice is to include CR&S in the depreciation

rate so that CR&S is accrued ratably over the life of the asset. The first proposal is to remove CR&S from the depreciation rate and record the net amount as expense in the period in which the equipment is retired. An alternative proposal is to make the elimination of CR&S optional so that each LEC can either treat CR&S as a current expense or continue the current practice of including CR&S as a component of depreciation expense.

In support of these proposals, the Notice discusses the estimation process that carriers must undertake in order to estimate the cost of removing plant many years into the future, a complex and inexact process that imposes substantial burdens on carriers, state commissions, and the Commission. The Notice tentatively concludes that prescribing net salvage no longer serves a useful regulatory purpose and that eliminating CR&S from the depreciation prescription formula would significantly reduce the regulatory burden associated with the depreciation reporting process.

BellSouth supports the Commission's alternative proposal to make optional the elimination of CR&S from the depreciation rate. BellSouth supports this alternative because it provides the LECs with the flexibility to continue to follow the existing practice which is GAAP, pending the issuance of a pronouncement by the FASB on the Accounting for Obligations Associated with the Retirement of Long-Lived Assets (i.e., cost of removal).

In June of 1994 the Edison Electric Institute ("EEI") asked the FASB to add an agenda project to address the accounting for the costs of decommissioning nuclear power plants. The FASB expanded the scope of the project to include similar obligations in other industries. In February of 1996 the FASB issued an Exposure Draft ("ED"), Accounting for Certain Liabilities Related to Closure or Removal of Long-Lived Assets. The accounting model proposed by the ED requires entities to record the present value of the estimated removal costs as a liability and

add this amount to the cost incurred to acquire, construct or develop an asset. This amount would then be charged to expense as depreciation over the life of the asset. The telecommunications industry filed comments asking the FASB to exclude telecommunications carriers from the provisions of this ED.

In October 1997 the FASB decided to continue with its review and is now proceeding toward the issuance of another ED (expected in the first quarter of 1999) that is expected to apply to all entities, and to require that retirement/removal costs be capitalized as a part of the cost of an asset. BellSouth believes the FASB will issue a final pronouncement by the end of 1999 (see Accounting for Obligations Associated with the Retirement of Long-Lived Assets attached as Exhibit 1).

As noted above, there is no difference currently between GAAP and Part 32 Accounting requirements for CR&S. If the Commission amends its rules to require that costs of removal be treated as expense in the period such costs are incurred and if the FASB issues a final pronouncement requiring that the present value of the removal/retirement costs estimated at the time an asset is acquired be recorded as a liability and capitalized as part of the acquisition cost of the asset, there will be an immediate difference in the accounting required by GAAP and the accounting required by Part 32 for removal/retirement costs. Carriers would then be faced with an increase in the cost of regulation due to the additional expense of tracking removal/retirement costs per the Commission's regulations and separately per GAAP. For this reason, BellSouth urges the Commission either to make no change in the current treatment of CR&S or to allow each carrier the option of treating net salvage as a component of depreciation pending a final pronouncement by the FASB on the GAAP accounting requirements for removal/retirement costs.

B. Despite Its Concerns, The Commission No Longer Needs to Regulate Depreciation

The Notice concedes that once “robust competition exists in the local exchange market, [the Commission] believes [its] depreciation process should be eliminated because it will be unnecessary.”¹¹ The Notice concludes that such competition does not exist in the market today, and identifies several “situations” that continue to require regulation of depreciation rates. For one of the situations identified, however, the Notice recognized that conditions could exist that would eliminate the Commission’s concern and states that “if [the Commission] can identify conditions that would eliminate the need for us to prescribe depreciation in the remaining situations we have identified, [it] proposes to allow carriers to set their own depreciation rates.”¹² Based on this concession, the Notice seeks comments “on what additional conditions could be imposed to eliminate [the Commission’s] need for depreciation prescription”¹³ relative to the other situations identified.

BellSouth will now address each of these situations individually and demonstrate that conditions exist that obviate any need for continued depreciation regulation. As a preface, BellSouth states that several of the situations the Notice identifies involve an event that might occur in the future, *e.g.*, a carrier could ask for a low-end adjustment. The cost of extensive prophylactic regulation to guard against such potential events clearly outweighs the isolated benefits that might flow from burdensome regulation. If a LEC triggers one of the situations the Notice identified, the Commission could establish test criteria to test the validity of the LEC’s depreciation expense. Such test criteria could include benchmarking against the LECs and other

¹¹ Notice ¶ 7.

¹² Notice ¶ 8.

¹³ *Id.* Of course, BellSouth, just as any other carrier, would retain its right to seek an above cap filing.

companies for financial reporting purposes, the most recently prescribed parameters, and other relevant criteria.

To illustrate, if a carrier, for example, sought to raise its price caps because its earnings fall below a prescribed level, the carrier could be required to file sufficient cost support, including depreciation expense, to justify its request. The Commission could require that the carriers use the Commission's test criteria to calculate earnings before the carrier could invoke the automatic low-end adjustment. If the recalculated depreciation expense yielded a result indicating that depreciation was not a factor in the event initiated by the carrier (a low-end adjustment for purposes of this illustration), then the carrier would have the burden to prove that the depreciation rates it used are proper.

Pursuant to BellSouth's proposal, by establishing test criteria to test the appropriateness of a carrier's depreciation expense for any "identified situation", initiated by the carrier, the Commission would obviate the need for burdensome proactive regulation. Accordingly, many of the situations the Commission identified in the Notice as reasons to continue depreciation regulation could receive adequate protection for any concerns the Commission may have even with the elimination of depreciation regulation. BellSouth identifies the appropriate situations in the following discussion.

1. Low-End Adjustments

The Notice states that "BellSouth suggests that the Commission allow carriers to set their own depreciation rates on the condition that they not seek an automatic low-end adjustment. This condition appears to address the low-end adjustment situation."¹⁴ BellSouth continues to support its position of waiving the low-end adjustment, under current price cap

¹⁴ *Id.*

rules, on condition that the Commission forbears from depreciation regulation.¹⁵ Additionally, BellSouth concurs with the Commission's conclusion that waiving the low-end adjustment would "address" the situation. By waiving this right, proactive regulation of depreciation on the basis that a carrier may file such an adjustment is completely negated.

Moreover, a low-end adjustment is a situation that must be initiated by a carrier. Accordingly, pursuant to BellSouth's proposal discussed above, the Commission could establish pertinent test criteria to be used in investigating the low-end adjustment. The Commission could use these criteria in the course of investigating the low-end adjustment. This would not be a burden on either the Commission or the carrier and provides adequate protection against any concerns the Commission may have regarding the impact of depreciation expense on operating results.

2. Recalculation of the Productivity Factor

The next situation the Notice identified as affecting forbearance of depreciation regulation is the recalculation of the productivity factor in the price cap formula. The concerns expressed by the Commission regarding the effect changing depreciation rates may have on the productivity factor are overly cautious. To prove this point, Frank Gollop, Professor of Economics at Boston University, performed a sensitivity analysis of the productivity factor to changes in variables such as depreciation rates. Professor Gollop's research concluded that moderate changes in the depreciation rates have no impact on the productivity factor.¹⁶ Accordingly, the productivity factor is no basis to deny depreciation forbearance.

¹⁵ BellSouth caveated its position to be dependent on the current price regulation plan. Any major change to that plan, such as movement to a prescriptive approach, could reinstate the need for low-end adjustments.

¹⁶ See Affidavit of Frank M. Gollop, attached as Attachment B to Comments filed by USTA in this proceeding.

3. Exogenous Cost Determination

A third situation in which the Notice claims calculation of depreciation remains significant is exogenous cost determination. As a threshold matter, the Commission has found that cost changes due to changes in depreciation rates are endogenous.¹⁷ Accordingly, any suggestion that cost changes due to changes in depreciation rates would require exogenous treatment is completely misplaced.

Moreover, it is speculative at best to assume that forbearance from depreciation prescription would materially impact the calculation of any exogenous cost determinations. Assuming that a revenue requirement methodology is contemplated, the impact of a change in depreciation rates would tend to be offset between the expense and return components. For example, an increase in depreciation rates would increase revenue requirements in the short run but would be partially offset by the corresponding reduction in return resulting from the higher depreciation reserve and lower average net investment. The precise impact, of course, would vary by issue.

Historically, the Commission has declined to issue specific rules or prescribe methodologies to calculate exogenous cost adjustments. Rather, it has relied on determinations from the investigation of a particular exogenous event as it did in the case of the LECs' January 1, 1998 Access Charge Reform Tariff Filings.¹⁸ In the Access Reform investigation, the Commission rejected the revenue requirement methodology advocated by most LECs and

¹⁷ Price Cap Order ¶ 182.

¹⁸ In the Matter of Tariffs Implementing Access Charge Reform, CC Docket No. 97-250, *Order Designating Issues For Investigation and Order on Reconsideration*, 13 FCC Rcd 2249, ¶ 47 (1998).

adopted instead a “permitted revenue” approach defined in the *Order*.¹⁹ As a result, it is not clear to what extent, if any, depreciation expense will be used in the calculation of future exogenous cost adjustments. It is clear, however, that any such event is almost certain to be evaluated on a case-by-case basis and in sufficient detail to identify (and, if necessary, to correct for) any potential impact of depreciation on the exogenous cost determination. [NOTE: ?]

4. Calculation of Base Factor Portion (“BFP”) for End-User Common Line Charges

In its *Access Charge Reform Order*,²⁰ the Commission prescribed rate structure changes so that non-traffic sensitive common line costs would no longer be recovered through traffic sensitive charges. As part of that change, the Commission raised the caps on multi-line business and non-primary residence end-user common line charges. Under the current rules the end-user monthly charge is set at either the cap, one-twelfth the projected annual per line revenue requirement, or one-twelfth the projected annual revenues permitted for the common line basket.²¹ The maximum charge per line will be based on a revenue requirement calculation until such time as the carrier common line (“CCL”) charge and the multi-line business presubscribed interstate carrier charge (“PICC”) are no longer required to recover any of the carrier’s common line costs.

Per the Commission’s rules, it is clear that the intent is to move away from the cost based approach as soon as possible thus eliminating the BFP calculation as a reason to prescribe depreciation rates. In addition, LECs’ calculations of projected revenue requirements have been

¹⁹ In the Matter of Tariffs Implementing Access Charge Reform, CC Docket No. 97-250, *Memorandum Opinion and Order*, 13 FCC Rcd 14683 (1998).

²⁰ In the Matter of Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Transport Rate Structure and Pricing and End User Common Line Charges, CC Docket Nos. 96-262, 94-1, 91-213 and 95-72, *First Report and Order*, 12 FCC Rcd 15982 (1997).

²¹ 47 C.F.R. § 69.152.

the subject of a recent investigation by the Commission.²² That investigation was initiated based on comments filed by interexchange carriers challenging that some LECs had understated end-user common line charges effectively reducing charges to the LECs' own end-user customers and increasing per minute CCL charges to IXCs. It is interesting to note that in these circumstances, the investigation was to determine if the carriers reported cost of service was too low. This would seem to be counter to the argument that a carrier would overstate its depreciation expenses.

Notwithstanding the fact that changes in depreciation expense are offset by the impact on return, increased depreciation expense would result in increased multi-line business end-user common line charges under the revenue requirement formula. Since changes in depreciation expense are endogenous events under today's price cap rules, any increase in end-user charges would be accompanied by a reduction in the CCL and PICC. In summary, the impact of changes in depreciation expense on LECs' end-user customers will serve as a check and balance until such time as the LEC moves to the permitted revenue calculation under the transition rule. At that point, depreciation expense would no longer impact the LEC's rates.

5. Cost Support for a Proposed Actual Price Index ("API") Higher Than a Carrier's Price Cap Index ("PCI")

Just as with a low-end adjustment, filing for a proposed API in excess of the PCI is a situation that must be initiated by a carrier. Indeed, the rule regarding a tariff filing that seeks to adjust the API states that it "must be accompanied by supporting materials sufficient to make the adjustment"²³ Once again, the Commission does not need to maintain burdensome

²² In the Matter of 1997 Annual Access Tariff Filings, CC Docket No. 97-149, *Order Designating Issues for Investigation, Memorandum Opinion and Order and Order on Reconsideration* (DA 97-1609), released July 28, 1997.

²³ 47 C.F.R. § 61.48(e).

depreciation regulation to ensure that the depreciation expense set forth in such a filing is proper. As discussed previously, any time a carrier files to adjust the API higher than the PCI, the Commission could merely determine whether the carrier's depreciation rates meet the Commission's test criteria. Therefore, concern over the possibility that a carrier may file for an API higher than the PCI as a basis for continuation of the prescription of depreciation rates is completely unwarranted.

6. Forward Looking Costs for Support Payments

The Notice claims that depreciation expense affects "federal support payments through new mechanisms created to implement the Telecommunications Act of 1996."²⁴ BellSouth contends that the Commission has confused the accounting for depreciation in the financial books with depreciation used in the cost model to calculate universal service recovery. The Commission, however, should view the two separately.

As discussed previously, depreciation for the financial set of books is the calculation of expense to recover the embedded cost of physical assets purchased by a LEC. This book depreciation is the subject of the docket and the item from which the forbearance is requested. The cost model for universal service, on the other hand, is based on forward-looking cost, not embedded cost. Accordingly, while BellSouth realizes that depreciation expense is a component of the universal service cost model, the Commission is misguided in its efforts to link the depreciation expense in the universal service cost model to book depreciation.

Similar to the earlier discussion regarding the establishment of depreciation test criteria the Commission could use this criteria in the event that a LEC triggers an event such as a request for a low-end adjustment, the Commission could also establish test criteria to be used for the

²⁴ Notice ¶ 6.

universal service cost model. For example, while some of the BellSouth states do not regulate depreciation ranges for regulatory reporting purposes, several states have selected forward-looking cost models and inputs for use in calculating universal service amounts. The states have simply set a range of depreciation rates for use in the models. The states have realized that the forward-looking costs calculated by the models are unrelated to the company's book costs.

7. State Commission Use

The Notice states that “state commissions have required incumbent LECs to use interstate depreciation rates or life and salvage factors developed during the Commission’s depreciation prescription process when calculating rates for interconnection or unbundled network elements.”²⁵ Pricing for interconnection and unbundled network elements are issues that should be left to the state PSCs. Once again, the Commission should not base a decision to continue regulation on potential events. While some state PSCs may require incumbent LECs to use the prescribed interstate depreciation rates for calculating these prices, other PSCs do not.

This is yet another situation in which BellSouth’s proposed establishment of test criteria to test a LEC’s rates is appropriate. The state PSCs could use the Commission’s test criteria to test the depreciation rates the LEC uses to calculate interconnection or unbundled network element prices. Accordingly, there is no need to continue the prescription of depreciation rates to potentially accommodate some state PSCs.

8. Takings Claims

The Notice concludes the paragraph in which it alleges situations that a “carrier’s depreciation remains significant” with the statement that “depreciation may play a role in a

²⁵ *Id.*

takings claim under the Fifth Amendment.”²⁶ Just as with many of the other above identified situations, the potential for a takings claim being filed by a carrier is no basis for the Commission to continue full-blown depreciation regulation. Indeed, BellSouth reminds the Commission that a takings claim could result from two possible scenarios – one of which favors forbearance, while the other can be addressed without the need for the current regulatory scheme.

Under the first scenario, if the Commission continues to set artificially long asset lives, thus resulting in low depreciation rates, as new competitors enter the market, free to set their own depreciation rates, the LECs will be forced to write off assets prior to receiving full cost recovery. If the Commission forbears from regulation, however, and allows carriers to set their own depreciation rates, just as the carriers’ competitors have a right to do, the carriers could not claim that the Commission denied the carrier a reasonable opportunity to recover its capital investment. Forbearance avoids this problem.

The second scenario would relate to the Commission’s concern that if it did forbear from depreciation regulation a carrier could set artificially high depreciation rates and drive its earnings artificially low. Presumably the Commission fears the carrier would then file for a lifting of its price caps on the basis that without such relief its overall earnings do not represent fair compensation for the cost of its services. As discussed in several of the situations above, the Commission establishing test criteria for depreciation lives easily eliminates this concern. Thus, if a carrier asserts a taking has occurred based on inadequate earnings, the Commission could simply test the carrier’s depreciation lives, and resulting depreciation expense, against the established test criteria. Moreover, under any takings claim, the burden remains on the carrier to

²⁶ *Id.*

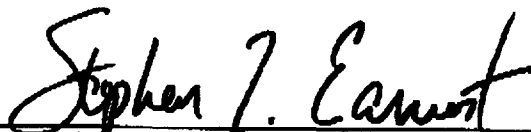
justify its costs, including depreciation. Therefore, there is no need for continued depreciation regulation to assist in review of a takings claim.

V. CONCLUSION

Based on the forgoing, the Commission should abandon its Notice of proposed changes to depreciation regulation and adopt the Petition for Forbearance submitted by USTA.

Respectfully submitted,

BELLSOUTH CORPORATION AND
BELLSOUTH TELECOMMUNICATIONS, INC.
By their Attorneys

A handwritten signature in black ink, reading "Stephen L. Earnest", written over a horizontal line.

M. Robert Sutherland
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Date: November 23, 1998

EXHIBIT 1

Accounting for Obligations Associated with the Retirement of Long-Lived Assets

The staff has prepared this summary of Board decisions for information purposes only. Those Board decisions are tentative and do not change current accounting. Official positions of the FASB are determined only after extensive due process and deliberations.

PROJECT DESCRIPTION AND OBJECTIVES

The objective of the project is to provide guidance for accounting for obligations associated with the retirement of tangible long-lived assets. The obligations included within the scope are those that are identifiable by an entity when it acquires and while it operates a long-lived asset, including obligations associated with post-retirement.

BACKGROUND

In June 1994, at the request of the Edison Electric Institute (EEI), the Board added an agenda project to focus on accounting for decommissioning costs of nuclear power plants. The original scope of the project related to the legal costs of decommissioning a nuclear power plant imposed by the Nuclear Regulatory Commission. Subsequently, the scope was expanded to include (a) similar legal obligations in other industries and (b) constructive obligations. An FASB Exposure Draft, *Accounting for Certain Liabilities Related to Closure or Removal of Long-Lived Assets*, was issued in February 1996.

Exposure Draft

In general, the Exposure Draft applied to all tangible long-lived assets for which there were associated legal or constructive closure or removal obligations. Legal obligations were described as resulting from laws, statutes, regulation, or contracts, and other obligations that are enforceable at law. Constructive obligations were described as being incurred when the actions or representations of the entity's management have directly influenced the reasonable expectations or actions of those outside the entity and, consequently, leave the entity with little or no discretion to avoid a future sacrifice of assets.

The specific obligations included within the scope were those that possessed the following characteristics that are listed in paragraphs 4(a)-(c) of the Exposure Draft:

1. The obligation is incurred in the acquisition, construction, development, or early operation of a long-lived asset.
2. The obligation is related to the closure or removal of a long-lived asset and cannot be satisfied until the current operation or use of the asset ceases.
3. The obligation cannot realistically be avoided if the asset is operated for its intended use.

The Exposure Draft proposed the following accounting model:

1. An obligation for closure or removal costs should be recognized as a liability when incurred.
2. The liability should be measured on a present-value basis, by using estimated future cash flows (derived from adjusting the current cost for inflation and certain advances in technology) discounted at the risk-free rate.
3. The offsetting debit should be recognized as an increase to the cost of the long-lived asset associated with the obligation. That is, the offsetting debit should be capitalized.

Comment Letter Responses to the Exposure Draft

Responses addressing the scope of the Exposure Draft may be summarized as follows:

1. Respondents were confused about whether the Exposure Draft applied only to large functional groups of long-lived assets or if it also applied to component parts of larger systems.
2. Many respondents indicated that the Board should either eliminate or provide more guidance about paragraph 4(a) of the Exposure Draft, which would have limited the obligations included in the scope to those incurred early in the life of the long-lived asset.
3. Respondents expressed confusion about whether the Exposure Draft applied to obligations that could be satisfied prior to the time than an asset ceases operation.
4. Respondents were confused about whether the Exposure Draft applied to assets with an indefinite or indeterminate life.
5. Many non-regulated industries may not have realized that the Exposure Draft applied to them.

Other comment letter responses were directed toward recognition and measurement issues:

1. A majority of the respondents supported the requirement to recognize liabilities for closure or removal costs as incurred.
2. Some respondents requested that the Board provide clarification of liability recognition events, especially as they relate to constructive obligations.
3. Some respondents said that the liability amount should be measured at current cost and that it should not be discounted.
4. A majority of the respondents agreed with the proposed requirement to recognize an asset upon initial recognition of a liability.
5. Many respondents indicated that asset retirement costs (debit) should be classified as an intangible asset.

REDELIBERATIONS OF THE EXPOSURE DRAFT (THROUGH OCTOBER 1, 1998)

In October 1997, the Board decided to continue with the project and proceed toward the issuance of another Exposure Draft (expected in the first quarter of 1999). Thus far, the Board has made tentative decisions with regard to: (1) the scope of the project, (2) identification of constructive obligations, (3) liability recognition and obligating events, (4) accounting for asset retirement costs (debit side) and cost allocation, and (5) liability measurement.

Scope

Consistent with the 1996 Exposure Draft, the scope of the project continues to apply to all entities. The scope of the project is expanded as follows:

1. The Board decided to eliminate paragraphs 4(a)-(c) of the 1996 Exposure Draft. Those paragraphs would have limited the obligations in the scope to those that (a) are incurred in the acquisition, construction, development, or early operation of the asset, (b) cannot be satisfied until the current operation or use of the asset ceases, and (c) cannot be realistically be avoided if the asset is operated for its intended use.
2. The Board decided that long-lived assets with indefinite or indeterminable lives and component parts of larger systems are included within the scope of the project.

To reflect the broadened scope, the title of the project was changed to "Accounting for Obligations Associated with the Retirement of Long-Lived Assets."

The costs included in the scope of the asset retirement obligations project are distinguished from those included in the impairment and asset disposal issues project. The asset retirement obligations project addresses costs identifiable by an entity upon acquisition and during the operating life of an asset, while the impairment and asset disposal issues project addresses costs identifiable by an entity concurrent with or subsequent to its decision to dispose of an asset.

Identification of Constructive Obligations

The Board tentatively decided that the bright-line distinction between legal and constructive obligations that was made in the closure or removal Exposure Draft may not be useful for liability recognition purposes. Therefore, the Board decided to shift the focus toward developing liability recognition guidance that would be consistent with the definition and characteristics of a liability in FASB Concepts Statement No. 6, *Elements of Financial Statements*, without making a distinction between legal and constructive obligations.

Liability Recognition and Obligating Events

The Board reaffirmed that an entity should recognize a liability for an asset retirement obligation when that obligation is incurred. The Board identified the following three categories, based on cost incurrence patterns, that an entity can use to identify obligating events requiring liability recognition:

1. Category 1--Obligations incurred upon acquisition, construction, or development of an asset
2. Category 2--Obligations incurred during the life of an asset, either ratably or nonratably
3. Category 3--Obligations incurred at any time during the life of an asset because of a change in (a) law, statute, or contract or (b) the representations of an entity.

Debit Side and Cost Allocation

The Board reaffirmed that an entity should recognize asset retirement costs as part of the cost of the related long-lived asset (that is, those costs should be capitalized). The objective of that capitalization requirement is to obtain a measure of cost that more closely reflects the entity's total investment in the long-lived asset.

Capitalized asset retirement costs should be allocated to expense by using a systematic and rational method. An entity is not precluded from using an

allocation method that would have the effect of capitalizing a cost and allocating it to expense in the same accounting period.

Liability Measurement

The Board decided that an entity should be required to use an expected cash flow technique to calculate the liability for asset retirement obligations. However, it also decided that an entity should not be precluded from using a computational shortcut, such as traditional present value or another estimation technique, provided the results are not expected to be materially different from a detailed application of an expected cash flow technique.

The Board discussed whether the measurement objective for the liability for asset retirement obligations should be fair value or entity-specific as those objectives are presently defined in the Board's project related to present-value-based measurements. The Board directed the staff to develop a fair value measurement approach that would be similar to the approach for estimating expected future cash flows for determining whether an asset is impaired that is required by FASB Statement No. 121, *Accounting for Impairment of Long-Lived Assets and for Long-Lived Asset to be Disposed Of*. That fair value approach will be discussed at a Board meeting during the fourth quarter of 1998.

REMAINING ISSUES

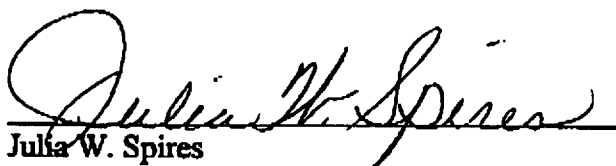
1. Liability recognition guidance
2. Measurement
3. Transition and effective date.

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CERTIFICATE OF SERVICE

I Julia W. Spires, do hereby certify that I have this 23rd day of November, 1998, serviced all parties to this action with the foregoing "COMMENTS OF BELLSOUTH" reference CC DOCKET 98-137, by hand delivery or by placing a true and correct copy of the same in the United States Mail, postage prepaid addressed to the parties as set forth on the attached service list.


Julia W. Spires

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